Deposit Competition: Returning Soon and More Intense Than Before.

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Before the COVID-19 ambush and the massive government counterattack to limit economic damage, banks were not swimming in liquidity as most are today. Before the pandemic, many institutions struggled to fund their balance sheets in the middle of a fierce competition for deposits. And those circumstances weren't restricted to just small banks. Less than three years ago, the CEO of a $47 Billion institution perfectly captured deposit gathering intensity, describing it as "*a steel cage match*." Nobody disagreed with him.

Fast forward to now. Some banks swimming in liquidity may think those cage match days won't return any time soon, but they're wrong. High octane deposit competition will almost certainly re-emerge, and the fight may be tougher than ever.

For most banks, Call Reports presently show strong asset quality, solid earnings, and plenty of deposits – indeed higher liquidity than most bankers have seen in their careers. Navigating unprecedented economic, social, and industry challenges over the past two years to arrive at this stable point is nothing short of incredible. But sustaining it will be difficult as various short-term economic defense mechanisms are reduced or removed. The Fed will be tapering its bond purchases and will likely raise interest rates. Pandemic specific unemployment benefits have stopped. Eviction and foreclosure moratoriums around the country are expiring. There are no more direct federal stimulus checks on the horizon. The substantial windfall of loan fee income from the PPP program will soon be finished.

Among the high-level indicators of present banking industry stability – earnings, asset quality, and liquidity – the one furthest from historical norms, and thus statistically more likely to recede as cash pumping pandemic programs are curtailed, is liquidity. That means banks will be returning to deposit wars, but on a more complex battlefield.

Community banks that have not fully modernized their deposit/payment products & services run the risk of losing deposits not just to more digitally capable banks, but to Fintechs – both those that have obtained bank charters (e.g. Lending Club, Jiko, Varo Money) and those who have not (yet) but who are attracting immense amounts of uninsured deposits (e.g. Chime, SoFi). And more well-funded Fintechs will soon enter the fray, either on their own or formally partnered with other banks. As this Fintech impact expands, the deposit gap – the difference between actual deposit balances and the amounts needed to meet liquidity needs – for technologically ill-prepared banks will also expand.

Many banks, especially community banks, experiencing deposit gathering shortfalls have historically relied on the FHLB as their primary, if not only, source of supplemental liquidity. While the FHLB will still be available to provide such funding, banks who rely on FHLB advances to cover larger and larger deposit gaps will become increasingly less competitive due to both the direct cost of FHLB advances and the balance sheet management complications that excessive reliance on FHLB will create.

While the pandemic greatly reduced M&A activity, that also will return at some point although the fundamental drivers may be different. Banks with less than competitive deposit products, payment options, small business treasury services, etc. will see growing deposit gaps, higher overall interest expenses, and an exceedingly difficult competitive landscape. There is still time to modernize these critical processes, but it will require a pedal to the metal sense of urgency to catch up, compete for deposits on a more level playing field, and ultimately avoid being an acquisition target just as M&A may be coming out of hibernation.